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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582 (Sub-No. 1)
Major Rail Consolidation Procedures
June 5, 2000

REPLY COMMENTS OF THE
ALLIANCE FOR RAIL COMPETITION

The U.S. Department of Transportation stated in its comments that a two-carrier system inherently brings with it a heightened risk of failure and the potential for *less than vigorous competition in all markets*. The Alliance for Rail Competition emphatically concurs with this assessment. In fact, existing merger policy has already produced two two-carrier systems, one each in the East and the West. The questions we face now are whether the Board will determine that the existing anti-competitive structure is acceptable and should be left unchecked, and then, whether the Board will allow even further anti-competitive consolidations to occur without changing its philosophy regarding and approach toward the role of competition.

In response to the filings submitted to the STB in this proceeding, the Alliance for Rail Competition has several general observations about the nature of the issues being considered by the Board:

1. Merger policy cannot and should not be reviewed separate and apart from day-to-day rail operations and/or regular policy analysis for the simple reason that merger policy affects every aspect of railroad economics, operations, finance, and overall performance. Merger policy is primarily responsible for shaping the rail system into what it is today, and revisions to that policy will inevitably determine the shape of the rail system of tomorrow.

2. While the downsizing that occurred as part of the last twenty years of rail mergers has been a factor allowing the financial recovery of the railroads, those same mergers also effectively reduced the number of available competitors. Further, because those mergers were not accompanied with adequate policy shifts that would ensure competition among railroads—a failing of the current merger policy—we now face such dramatic market concentration that significant reforms are necessary, as recognized by the Board's initiation of this proceeding. The means for returning competitive forces to the rail industry is inextricably linked to how the Board considers the merits of future mergers.

3. While mergers may provide certain operating efficiencies, mergers effectively reduce the number of competitors in any given market. Thus, mergers do not <u>create</u> more

competition— unless specific countering measures are taken that give the remaining non-merging competitors an opportunity to serve new markets through the imposition of conditions such as trackage rights. However, these types of conditions generally have been applied only occasionally, and then to limited markets, and thus, rail mergers still have had the cumulative effect of reducing the overall number of competitors—and thus the number of competitive alternatives—available.

4. The breadth of authority enjoyed by the Board under the merger portion of the statute provides sufficient latitude for significant competitive improvements to today's monopolistic rail system. However, interpretation of statutory authorities is subjective. Thus, recognizing the potential variations in interpretations, clear congressional direction remains a necessary and appropriate element of comprehensive rail policy reform. For the sake of creating good public policy that can help mold our future rail system into one that is competitive, safe and financially stable, the Board should advocate specific legislative action for Congress to consider regarding these issues.

Beyond these general reflections on the nature of this proceeding, ARC submits the following in response to some of the specific issues raised by other parties of record:

Public Interest Standards:

There has been much discussion in this proceeding about "public benefits" and the "public interest," but what exactly constitutes the public's best interest has never been precisely defined. The Alliance for Rail Competition would argue that the purpose of the rail industry is to provide a service that allows other companies to produce and/or deliver a consumable product. If a railroad does not meet the needs of the companies it is supposed to serve—its customers—then the railroad has no purpose. Perpetuating its existence regardless of its performance offers no public benefit and is not in the public interest. Thus, any railroad activity that undermines the value and/or performance of rail service to its customers is not in the public interest. It is clear that the Board needs to apply specific definitions of what it believes constitutes public interest.

Relationship between Merger Policy and Competitive Structure:

Some participants in this proceeding have urged the Board to avoid using this review of merger procedures to change regulatory philosophy or alter the competitive structure of the industry. However, the very fact that this proceeding had to be initiated argues for the need to change regulatory philosophy. As the Board duly noted when initiating this proceeding, "our current rules are not adequate for addressing the broad concerns associated with reviewing any proposals that, if approved, would likely lead to just two large North American transcontinental railroads." In fact, the application of existing merger policy over the past 20 years has altered the competitive structure of the industry with each decision on each transaction. Whether it is left intact or is changed to more adequately reflect the need for enhanced competition among railroads, merger policy will continue to inherently shape the rail industry. With the exception of the major Class 1 railroads, all parties, including both federal and state government agencies, advocate changes to merger policy that would introduce additional competition into the railroad industry.

Service Performance Issues:

By most accounts, railroad mergers were supposed to correct service deficiencies, rather than exacerbate them. Instead, we hear from railroad executives that the service problems are to be blamed on satiated yards and terminals, caused by "short-term" merger integration problems. Unfortunately, these "short-term" integration problems have stretched on for years, and often, even though the worst of the integration problems are resolved, pre-merger promises about dramatic improvements in service or stable rates are never realized. This is clearly a rail management problem, yet other than regulatory oversight and monitoring of railroads' efforts to correct post-merger service crises, there have been few real penalties for their failures—either for the resulting service disasters or failures to live up to promises made. Thus, it would seem that railroads who have had merger-related service failures and/or have yet to produce the stellar service improvements promised prior to their merger should have very little credibility when taking the position that "the imposition of a system of pecuniary awards is misguided". Ideally, carriers should be held responsible for the full-established consequences of their failures, and regulators should be prepared to impose any of a broad range of regulatory imposed sanctions—including but not limited to fines, financial awards to customers or access, including potential divestiture of certain lines—as deemed appropriate given the nature and extent of the service failure. Use of such enforcement tools is common practice for other regulatory agencies that oversee mergers in other industries.

Furthermore, it has been suggested that temporary integration problems have no competitive effects. Recent service crises have demonstrated how extremely vulnerable customers are when service failures occur and there are no competing railroads available to help mitigate the problems. These are competitive effects on the customers as surely as if there were not multiple transportation options. It is in no one's best interest to allow concentration to reach the point where there are simply no other remaining service options in the face of widespread service failures, yet that is the situation we face today.

In the end, the best form of insurance that any given railroad will perform as promised is the threat that that railroad could lose its business to a competitor—even if temporarily. A merger policy that allows any railroad the luxury of having few or no competitors for the bulk of its business—as has already occurred—is inconsistent with the public interest and must be changed. Furthermore, as a failsafe, the Board must have enforcement tools in place that it is prepared to use in the event that all the promises of improved efficiencies that a merger transaction will produce are broken.

Application of new merger policy to large versus small railroads:

Other participants have suggested that only the largest railroads should be subjected to changes in merger policies. Clearly, our concern at this moment is the further concentration of the largest railroads into transcontinental monopolies. Many, if not all, smaller railroads have much to lose if that were to occur, potentially becoming as vulnerable to the whims of those monolithic railroads as their customers are today. The Alliance for Rail Competition recognizes smaller railroads as a critical component in the effort to return competition to the industry. To that extent, we would not want to see policies adopted that would prevent them from creating the networks they need among themselves to provide competitive service options, although it is likely that such networks could be formed outside of actual merger transactions.

Nonetheless, if smaller railroads are exempted from consideration under more stringent merger policy standards, they could conceivably be acquired more easily by larger railroads that have an interest in eliminating the emergence of a network of smaller railroads that could pose a competitive threat. This would not be a desired outcome. In addition, a series of mergers among small railroads that would eventually become another mega-railroad would not be a positive development. In short, the competitiveness of the entire market affected by any railroad merger—whether railroads are small or large—must be taken into account.

Artificial Selection of IMCs:

As noted by the Transportation Intermediaries Association, railroad market power has become so strong as to allow railroads to arbitrarily pick and choose among certain categories of intermodal marketing companies (IMC) providers thereby determining winners and losers within that customer group. The railroads' behavior toward small and mid-sized IMCs demonstrates how unwilling railroads are to look at new ways to expand and grow their customer base. Railroads often claim that intermodal business is their best growth opportunity. Yet, their actions eliminate IMCs that can gather together business that would otherwise move by truck. Such behavior is fundamentally wrong, contrary to the intent of the Staggers Act and demonstrates yet again that the extreme level of railroad consolidation that exists today is not in the public interest. The STB should adopt appropriate rules that ensure that railroad market power cannot be used to determine the fate of its customers.

The Siphoning of Scarce Resources:

Several railroads have claimed in their filings that competition—whether introduced as a condition of a merger or otherwise—would effectively deprive carriers of the returns upon which they depend to attract capital, reinvest in their rail networks and maintain and improve service.

While this often has been claimed as an impact of introducing competition, it has never been demonstrated when applied to any network industry that has transitioned from a monopoly to a competitive industry. In fact, the competitive process itself is the best means of achieving the needed balance between cost and quality of service. The applicability of competitive forces to the rail industry is explained in great detail in the verified statement of Professor Robert E. McCormick, attached to the comments of the Chemical Manufacturers Association and the American Plastics Council submitted in this proceeding.

Furthermore, based on conservative projections made in an analysis commissioned by ARC, increased competition among the nation's rail carriers would result in a $500 million improvement in net rail profit by 2005 thus allowing the rail industry to sustain the gains made since the passage of the Staggers Act in 1980. The benefits in terms of additional revenues and profits more than offset any rail rate reductions that might occur when currently captive traffic is opened to competition. Conversely, if the railroad industry does not adequately address the transportation problems that have been caused by undue market concentration and insufficient attention to customer needs, railroad traffic growth—identified as the most important factor in future availability of capital—will be affected negatively.

The railroads' view that any Board action introducing competition is "regulation imposed competition" or "forced access" requires one to endorse the alternative—monopoly control—as acceptable. This was not the intention of deregulation under the 1980 Staggers Act.

Rail Industry's Arguments Regarding Capital Need are Flawed:
The Board should not be distracted from its mandate of encouraging competition among railroads by misleading claims that such competition would somehow limit or eliminate capital resources. Consider the following points:

1. In competitive industries, some companies fail, some are acquired, some merge, and some prosper. When good and poor performances are combined to calculate an average industry statistic, the result can be misleading. The rationalization of the railroad plant was a natural market phenomenon in which some railroads remained financially strong and had no difficulty in attracting capital.

2. The four dominant railroads have no history of capital shortfalls. When the Staggers Rail Act was passed in 1980, the current four dominant railroads had relatively sound earnings as reflected in the following rates of return on equity: NS (16.1%), CSX (12.5%), BN (10.2%) and UP (10.2%). These railroads remained strong throughout the 1980s and most of the 1990s, as illustrated by their 1996 returns: UP (16.6%), NS (13.7%), CSX (11.7%), and BNSF (11.4%). Collectively, they spent about $20 billion to acquire other railroads. Clearly, there were no capital shortfalls for these railroads over the past two decades.

3. Capital need and depressed stock-market prices are not synonymous. Railroad stock prices are depressed in the same manner as other companies in the "old economy." Many non-railroad companies, who enjoy adequate earnings, strong financial structures, and an abundance of capital, have seen their stock prices tumble.

4. A significant portion of capital need, for example, equipment investment, has been pushed to others (including, customers), and plant investment is largely funded through internal funds and debt.

5. It is natural for investors to suffer when expectations of merger benefits are not realized. When railroads pay premium prices to acquire other railroads on the basis of prospective benefits that do not materialize, investors should suffer the consequences. After all, it is the investors who took both the upside and downside risk associated with railroad pre-acquisition claims. Unlike customers who depend on single-railroad service, investors have alternative opportunities.

6. There is no credible evidence that railroads are capital deficient. BNSF continues to be a thriving railroad (14.8% return on equity in 1998 and a strong 1999 performance), while the other three dominant railroads are in post-acquisition, transitional periods. Still, they have been able to fund their newly acquired debt and make substantial capital investments. For example, the March

1, 2000 edition of U.S. Rail News reported that in 1999 CSX invested $1.4 billion and NS $2.8 billion respectively, in new plants and expansions along their lines.

While railroads must have the prospects of earning adequate profits to attract capital, such prospects should not emanate from insufficient service and monopoly pricing. New and existing industries attract additional capital by convincing investors that the industry can create sufficient new value for customers to allow the industry to recover its investment, earn a return on the investment and satisfy customers. Rail customers do not propose to "re-regulate" railroads. Customers are not interested in simply increasing their share of the value created. Regulation can never simulate the efficiencies of open markets. Rail customers want a more dynamic industry that increases the "size of the pie." Furthermore, railroad-customer confrontation, costly and lengthy regulatory proceedings, and a maze of complex regulations are not in the interest of either railroads or their customers. Quite simply, railroad customers want what other customers already have -- choice. The introduction of competition to highly capitalized industries has improved performance and earnings, despite prior claims to the contrary. There is no reason to expect railroads to fare any differently. Using shareholders' disappointments in rail earnings as a reason to endorse the railroads' position on competitive policies is not in the public interest and is bad economics.

Rail Customers Are Unified:

In conclusion, the rail customer community is increasingly unified about the underlying problems of the rail industry and in general, has coalesced around the idea that public policy must begin to focus on competition as the solution. While individual recommendations of how to best do this may differ, there is general agreement on the direction this policy proceeding should take. Furthermore, all of the recommendations that would promote increased competition among railroads, improve service and safety, and correct anti-competitive actions of the past bear serious consideration, and many should be tested in real world applications.

Many members of the rail customer community recognize our growing consensus on issues raised by the concentration of railroad market power in the U.S. and the danger of the emergence of two huge monopoly railroads in North America. Our consensus is reflected in the following pro-competitive principles, which should guide the Surface Transportation Board in its development of improved policies and procedures:

- Stronger action must be taken to hold merging railroads accountable for their promises of improved service and more efficient operations. Promises that are not, or can not be, incorporated into binding contractual obligations should not be accepted by the Board during merger proceedings.
- The severe service problems that have resulted from past railroad mergers must be prevented and/or mitigated through effective remedies, including performance guarantees, compensation and access to other railroads.
- Current regulatory policies, including the bottleneck decision, the "one-lump" theory, and the "2-to-1" rule, have failed to prevent the reduction of competition among major railroads, which now enjoy unprecedented market power.

- The regulatory policies of the past, which the STB has recognized as inadequate and which even many railroads are now recognizing as flawed, should be replaced by new policies aimed at promoting competition.
- Access remedies such as trackage rights and switching on fair and economic terms should be more readily available, whether or not there are future mergers.
- Contractual and operational barriers to competition from smaller railroads should be eliminated or reduced, whether or not there are future mergers.
- Gateways for all major routings should remain open on reasonable terms.
- Adverse impacts of rail consolidations on the safety of rail operations and on the interests of rail labor should be mitigated.
- Cross-border mergers should not interfere with effective regulation and the enhancement of competition; and
- Railroad mergers can no longer be considered in isolation.

The need for improved and enhanced competition along these lines is so strong and immediate that the STB should use the full extent of its authority to revise its policies consistent with these principles. The Board's efforts in Ex Parte No. 582 (Sub-No. 1) should include, but not be limited to, all of the recommendations in the proceeding that would:

1. Increase competitive alternatives for customers among railroads;
2. Improve service and safety; and
3. Address any problems or flaws—present or future—which result directly or indirectly from rail mergers.

Recognizing that the Board may not have the necessary authority to fully achieve comprehensive policy reform consistent with all of the above-listed principles, the rail customer community will continue to press for congressional action that would provide the necessary legislative direction to achieve these principles.

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CERTIFICATE OF SERVICE

I hereby certify that this statement of the Alliance for Rail Competition has been duly served on all Parties of Record identified on the Ex Parte 582 (Sub-1) service list via first class mail in the United States Postal Service this 5th day of June, 2000.

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